**Abrami, et al.**

**ACHIEVING COMMERCIAL SUCCESS IN CHINA Hazardous Business**

We have focused on the context of the China business environment and how it has emerged. We have recognized the overwhelming presence of the Party-State and the vast economic differences between regions. We have noted the dramatic build-out of hard infrastructure and the challenge of sustaining a culture of innovation in China. All this has been accompanied by 300 million people lifting themselves into the middle class and beyond. In this environment, state-owned enterprises have thrived, and so too have numerous foreign companies and countless local entrepreneurs. Many non-state-owned firms with ambitions for significant growth, however, have failed for reasons that have to do with their inability to design a strategy that suits China’s unique environment.

Four in particular dramatically differentiate the business environment in China from that of the West. A firm that masters them may meet with success; ignoring them can lead to disaster: Sensitivity and adaptation to the requirements of the Party-State at the national level. Sensitivity and adaptation to the requirements of provincial and municipal Party administrators and government. Identifying the opportunities posed by emergent technical infrastructure and navigating the shoals of weak or nonexistent soft infrastructure. Visualizing and acting on the opportunities of a rapidly emerging consumer economy at both the high-end and mid-market level. In this chapter , we have chosen a series of companies, some successful and others not, whose stories we think are particularly instructive. We have analyzed their success and failure through those four lenses and highlighted important nuances in execution.

**Nation, State, and Party Alignment**

The Party -State is critical to the success of all firms, especially if they seek to expand or diversify their activities. Sustained Party-State linkages over long periods of time and across all geographic areas where a firm is active are essential components of any business plan in China; creating and maintaining these relationships demands a highly qualified team of public affairs specialists working on your firm’s behalf. Some business opportunities that make sense in other countries might be ruled out in China for reasons of government sensitivity. Conversely, strong political favor may be shown to foreign companies that bring special assets to China in terms of technology transfer, new industries, and employment.

**Sustained Government Support**

While there are many means by which the central government and Party shape China’s business environment, the most fundamental is a firm’s need for continuous engagement with both of them. No case is more dramatic in this regard than the emergence of Wanxiang, today’s global automotive parts giant. Wanxiang began in 1969 as a Commune and Brigade Enterprise (CBE) in Hangzhou, Zhejiang, in Eastern China. 1 As a CBE , it was a legal entity whose primary purpose was to fulfill government planning objectives, including the self-sustainability of the rural

community in which it was based . CBEs were given minimal support from the central government. They depended heavily on the energy, know-how, and relationship-building abilities of their leaders.

Lu Guanqiu, Wanxiang’s founder, whom we met in chapter 1 , is one such individual. He initially made use of a unique feature of China’s socialist era policies, namely its official abhorrence of “wastefulness” in a rather wasteful system. His is a story of “swords into plowshares,” for he obtained outdated field artillery ordnance from the People’s Liberation Army and transformed it into plows that could be sold to surrounding rural areas. In following years, the CBE expanded into nonfarm products, most famously auto parts. Here Lu Guanqiu identified another gap in China’s planning system— the ability to supply timely, high-quality provisions— and resolved it.

Within a decade, and now doing business as Wanxiang, Lu’s company had developed a strong regional reputation. It ultimately won a place in the national state plan to produce universal joints for autos and trucks. It was only one of three firms out of hundreds to win a contract to supply China’s state-owned automotive companies at the beginning of their expansion.

The firm’s relentless focus on high-quality maintenance of local government support and an ability to translate gaps in the state provisioning system into market opportunities were core factors behind Wanxiang’s success. Given its origins as a CBE, Wanxiang was not part of the system by which the state assigned workers and university graduates. Determined to recruit the best talent, Wanxiang offered special bonuses to universities that directed their best students to the company, solving cash flow problem for universities and laying the foundations for the enterprise’s long-term growth. In 2013, Wanxiang expected to reach $ 20 billion in global sales, with about $ 3 billion in the United States. It has about 40,000 employees— a figure that is changing all the time, according to Wanxiang America President Ni Pin— with 12,500 people under Wanxiang America. Wanxiang has been transformed into a dynamic holding company that has made acquisitions in China and around the world in sectors that complement the Chinese government’s strategic goals (for example, clean energy) and allow the business to remain hugely competitive. Indicative of the company’s scale and status, Lu Guanqiu was invited to join President Hu Jintao’s delegation during Hu’s 2011 state visit to the United States. Even before meeting the American president, President Hu Jintao visited Wanxiang’s US headquarters in Chicago, with Lu beside him.

**Establishment of Special Economic Zones**

The central government established special economic zones (SEZs) with embedded utilities and other infrastructure to attract foreign companies doing export work, and with the broader intention of facilitating technology transfer and other positive spillover effects. SEZs have been critical to the incubation and emergence of many important Chinese companies.

The first nationally authorized trade zone was established in Shenzhen in 1980. Located near Hong Kong, it was an experiment to see how market capitalism could work in a socialist context. Its creation sparked the forces that enabled the Pearl River Delta area to

become one of the world’s great manufacturing zones. Shenzhen grew from a population of 310,000 in 1980 to nearly 10 million in 2011.

The model of the special economic zone was replicated across China with the support of both national and provincial authorities as Shenzhen and other early zones showed great results. SEZs have been established recently in interior regions to encourage growth where it has lagged behind the rest of the country. At the beginning of the twenty-first century, there were fifteen free trade zones, thirty-two state-level economic zones, and fifty-three high-tech zones. 2 These zones have been accompanied by the establishment of science and technology parks, which aim to provide the climate and infrastructure for advanced technology firms to emerge.

One firm to emerge from these gestation zones is UFIDA, which rode the wave of electronic accounting that was sweeping the government sector in the late 1980s. 3 Now a fourteen-thousand-employee company, UFIDA was launched in 1988 in the newly formed technology park— designed to replicate Silicon Valley’s success in the United States— located between Tsinghua University and Peking University in Beijing. UFIDA’s CEO, an employee in a government agency, took the risk, with the support of his superiors, to leave the government and establish the company.

Headquartered in Beijing (the destination for some of the best students in the country), UFIDA consciously built dormitories and high-quality office space to attract and retain graduates who didn’t want to leave the city. As the needs of its government agency and SOE customers changed, UFIDA ensured that these demands were understood and appropriate adaptation made to its products and services. In addition to its customer-centric approach at home, UFIDA also tracked the product development and acquisition plans of its two large, global competitors, SAP and Oracle. With a firm foundation domestically, UFIDA could see where the industry was going internationally and race to offer competing products . Because indigenous innovation was a national priority, UFIDA had a natural edge over foreign competition , as the government and SOE customers largely favored it. Only in the case of the largest Chinese companies did SAP and Oracle beat UFIDA.

Location was such an important advantage for sales and staff recruiting for UFIDA in the information technology industry that Kingdee, UFIDA’s Shenzhen-based competitor, ultimately moved offices and staff to Beijing to get a share of the Beijing SOE market and benefit from the city’s rich human resources. 4 UFIDA also benefited from a well-timed, government-supported IPO on the Shanghai exchange that gave it considerable financial resources for multiple acquisitions and R& D.

In sum, UFIDA’s success and growth have been a function of being located at the center (geographically and otherwise) of a robustly supported national priority. It was founded in the right industry at the right time, getting access to the best students and a variety of tax and other economic concessions, as well as having a very strong ex-government CEO. The core of its success, however, was a central government providing the context for the company to succeed.

**Party and Government Shape the Possible**

The Chinese Communist Party and the Chinese government can give (as in infrastructure investments) and they can take away (as in licensing and land access). To succeed, an entrepreneur needs their active support, or at least their benign neglect.

China’s political system rules out certain classes of investments that are possible in other parts of the world (think newspapers, for example, and Rupert Murdoch’s failure in China). No sector has experienced these limits more than the modern information industry.

Internet search engines such as Yahoo! and Google are the standard examples. Each company’s leadership has had to contend with the ethical dilemma of whether or not to censor as dictated by the Chinese government. 5 Search terms like “June 4th Tiananmen” or “Jasmine Revolution” remain blocked. Foreign businesses must also contend with the government’s demand for the search histories of individuals and organizations that it deems threatening to social stability.

Google resisted these policies. It made the decision to limit its activities in this market, and it made clear to China-based customers when they were searching for something “unavailable” in China. Chinese firms do not have the luxury of taking such a public stance, and some have benefited from the exodus of a range of foreign internet-based businesses. Google’s local competitor, Baidu, for example, now dominates the China search market with a 67 percent market share, though it remains unknown outside China. Google now serves its Chinese customers from Hong Kong, but Facebook, with its ability to create broad social networks, was unable even to enter China. Instead, a Chinese firm— Renren— has dominated this space, working closely with government monitors to ensure its continued operation. Similarly, in place of Twitter , China has “Weibo” microblogging sites where followers run in the millions, but under the ever-watchful eye of monitors.

**Dorm99**. An instructive case of a firm’s failure to survive in this environment is Dorm99, a four-year-old start-up founded in 2007 by two HBS students during their second year in the MBA program. 6 One was a Chinese American who had already built two other ventures (and sold one). The other was a Chinese national , well connected politically, who had done his undergraduate years in the United States and then worked there for several years. Their concept was the creation of a university student Facebook-like site that would make it easier for students within and across universities in China to get to know another. It was a powerful idea for its time. The founders struggled to find the hook that would pull people to the website and entice them to register as users . Eventually, they conceived of putting a click-through ad on a non-governmentally owned and managed website that students accessed on a specific date to see if they had passed the national English examination administered twice a year to university students (passing this examination was a requirement for graduation). All the website told them was whether they had passed the test. However, if students signed up for Dorm99 by clicking on the Dorm99 icon and thus becoming customers, they could also find out their personal score as a percentile of both their university and their province, information that they could then share with potential employers . The founders believed this information would be of great interest to the students. They were right.

When the system was brought live, it was a great success. In the first four hours of operation, Dorm99 generated nearly two

hundred thousand customers. Just as the founders started to savor success, however, they received a call from the Ministry of Education, demanding that this “unharmonious site” be closed down immediately. The founders thought they had covered their government political bases well enough, but they had not factored in the government’s reaction to calls from angry parents, upset that their children had passed the test but only at the fifteenth percentile (information that had been previously unknown). This was just too much trouble for the Ministry, and a promising venture was derailed by political fiat. The company could not be revived in its planned form and eventually morphed into a university-sponsored student gaming platform, where it has languished. The lesson here is that it can be very hard to understand the multiple interests of the Party and state at various levels, even for the well connected. The penalties are harsh if you get it wrong. The government and Party have life-and-death control over any business, making China a very nontransparent place to do business. Dorm99 is the poster child for this type of failure; great guanxi (connections) could not sustain this business.

**Special Value to China**

No point is more fundamental for a foreign organization seeking to do business in China than this: the goal of making a profit is an insufficient reason for the government to support you. You must show, at both the national and local level, how your organization provides value for the country and the province/ city. If you facilitate technology transfer, improve the standards of living, extend life expectancy, and so forth, you are welcome. Your contribution may take many forms. For example, Blackstone’s 20 percent minority investment in a large division of ChemChina was valued not just for the money it brought in but more importantly because of its transfer of sophisticated governance mechanisms to a Chinese company. 7

**The Esquel Group**. An example of bringing special value to China is the Esquel Group, a $ 1 billion manufacturer of woven shirts for high-end international markets. 8 This firm is in the fourth generation of a family textile business with a rich tradition of corporate social responsibility . It has brought the latest textile manufacturing equipment and processes to its twenty -three-thousand-employee plant in Gaoming City of Guangdong Province, where it is a famously green, or environmentally sound , company. It is also a large purchaser of cotton from the Xinjiang Production and Construction Corps, in Western China. Esquel is vertically integrated on every step of its supply chain, and it controls quality relentlessly. It is vertically integrated, too, in its necessary political and social relationships. It is involved in every aspect of government, from running the local power plant to the service of its chairman, Marjorie Yang, on the People’s Political Consultative Conference at several levels and also on two Chinese university governing boards . More than 50 percent of the chairman’s time is spent on these activities. The net benefit has been the ability to gain access to material resources for the firm and the ability to expand. Esquel is one of the best examples of bringing special value to China beyond jobs.

**Capital Rationing**

Capital availability constrains the emergence of successful start-ups. Foreign capital from overseas Chinese families and stock listings has often been the only source for those firms. This is a result of the government’s policy to support financially major state-owned enterprises and move those that cannot make it to relatively soft landings through mergers or closures if necessary. To enable an orderly reconfiguration of state-owned enterprises, the major banks at government direction focus their lending activities on fulfilling the liquidity needs of these enterprises. Consequently, much of the medium- and larger-scale entrepreneurial sector has been financed by a combination of foreign venture capital and the firms’ internally generated cash flows and, in recent years, flotation on the Shanghai and Shenzhen stock exchanges. The establishment of these two significant stock exchanges in 1990, post– Tiananmen Square, has been critical. Their creation opened access to capital from inside China to private firms for the first time, but only for firms approved by the government for listing.

These government-imposed capital scarcities shape the kind of entrepreneurial institutions that can survive (that is, those that have no need for externally supplied capital or can attract foreign capital or stock market support). This scarcity has also opened new business opportunities. An interesting example of a new organization that provides money to entrepreneurs is CreditEase.

**CreditEase**. CreditEase is a 2007 microfinance platform start-up that grew from thirty staff in 2009 to over seventeen thousand by the end of 2012. It operates in China’s very inefficient capital market space for small loans. Normally, the only sources for loans for small business are family, friends, and local loan sharks (who charge exorbitant double-digit monthly interest rates). CreditEase’s product strategy is aimed at this problem. It was founded by Ning Tang, a Chinese citizen who did two years as a math major at Beijing University, followed by two years at the University of the South in Sewanee, Tennessee, as an economics major. This was followed by tours in the New York offices of several financial houses, including DLJ Financial, before returning to China. As a result, he has a deep understanding of how the credit markets work. The company is currently backed by Kleiner Perkins Caufield and Byers and has expanded across more than fifty cities.

In the absence of a national credit history system in China (such as Equifax in the United States), CreditEase has developed a group of two hundred individuals who can do sufficient checking of various sources— employment, bank accounts, and the like— to become comfortable with an individual’s risk of nonpayment. So far, the default rate has been well under CreditEase’s budgeted 2 percent rate (of course, the company is young and has not yet been tested by a recession). Its business model is to find funding sources (high-net-worth individuals) who are looking for a high, relatively risk-free rate of return. CreditEase matches these sources of funds with people who need additional funds for their businesses and have the apparent capacity to repay them. CreditEase is the middleman providing the platform that enables the connection between the two parties. It bears no risk on the loan (it charges a fee for providing this service to both sides of the transaction).

CreditEase is an example of the opportunities that exist in the nooks and crannies of the Chinese infrastructure as the country moves to close a sixty-year-plus manufacturing and service gap with the West. This company’s value is in creatively creating access to

capital in a capital -starved environment in a way that has kept the government regulators comfortable to date. It provides capital for job creation in organizations that existing financial organizations are unable to serve. It lives, however, on a razor’s edge. Like Dorm99, it could be stopped in an instant if it crossed people at the ministries, and so its leaders tread softly and carefully. The company’s roster is filled with MBA graduates from prestigious American and Chinese universities. The company is truly exciting, but also vulnerable in a way a US firm would not be. CEO Ning Tang is also the head of the company’s Communist Party and was recently named an “Outstanding Communist Party Member in Beijing”— important signs of how well he is managing those linkages.

In short, the role of the state and Party is all pervasive not only in state-owned enterprises but also in almost all foreign and private organizations of any scale. Mastery of Michael Porter’s classic five forces analysis or his value chain simply is not enough to survive in this environment. 9 Government and Party in all their various aspects permeate every corner of corporate life. It is the invisible sixth force.

**Local, State, and Party Alignment**

China may be one country, but it is composed of multiple regions with different economies and capacities. The stories of the Charoen Pokphand Group (CP Group), the city of Kunshan, and ReSource Pro are instructive.

**CP Group**. The CP Group, one of the world’s largest agribusinesses, has done much to transform Chinese commercial agriculture in recent decades by establishing an integrated supply chain “from farm to fork”; that is, from animal feed to animal husbandry to food processing to marketing in CP’s own supermarkets. 10 In twenty-eight provinces, it has overseen an agricultural and commercial revolution without a land revolution. It has done so province by province, replicating and, as needed, “localizing” its approach in each setting, for there still are no easy national markets for pork, poultry, eggs, and seafood.

In close partnership with the municipal government of Cixi, in Zhejiang, south of Shanghai, the CP Group is experimenting with the future of Chinese agriculture. The local government has leased to CP nearly eighty square kilometers of land reclaimed from Hangzhou Bay. There it has invested $ 1 billion in a modern agricultural and ecological farm of enormous proportions. Hundreds of greenhouses nurture organic vegetables. Thousands of four-acre plots of formerly saline soil are planted mechanically for wheat, barley, and rice. The fields are fertilized by the manure of the thousands of chickens, which also lay 1 million eggs a year. The chickens, having done their work, are processed for soup, and some will find themselves recycled, sadly, to the alligator farm. Energy for the enterprise comes from multiple wind farms on site. The CP Group has a national and international reputation, but it needs local partners. Without the support and infrastructure given by Cixi, it could not succeed there.

**Kunshan**. One of China’s greatest local success stories is that of the city of Kunshan. 11 When China reopened its doors to global economic interaction in 1978, Kunshan, in Jiangsu Province, possessed little promise of becoming a future hub of international trade. Its most famous modern businessman , An Wang, had made his career in America, inventing the Wang word processor. A small farming community approximately fifty kilometers west of Shanghai and thirty-seven kilometers east of Suzhou, Kunshan was more famous for its mitten (or hairy) crabs, which can be found in Shanghai restaurants in season, than it was for its manufacturers. It had minimal resources to take advantage of its fortuitous positioning between two major cities in the Yangzi Delta . Through a combination of local government ambition, local entrepreneurs , and overseas investment (especially from Taiwan) in a little over two decades’ time, Kunshan was transformed from an agricultural nowhere into a highly globalized urban tech cluster.

When the central government opened fourteen coastal cities as newly designated economic and technological development zones (ETDZ), Kunshan was not among them. Not wanting to wait for state recognition, the local government leaders decided to establish their own development zone in 1984. 12 The Kunshan Economic and Technological Development Zone was born in 1985 as the PRC’s first high-tech industrial park . Even though it was established without permission, its success was such that it went unpunished. Over the last three decades, Kunshan has been home to many of the world’s top information technology and communications manufacturers, including Foxconn, Compal Electronics, and Wistron Corporation, as well as consumer goods companies, including Giant Bicycles, and a local powerhouse that dominates global markets for children’s goods, the Goodbaby Group.

In all of this, the key supporters of business have been Party officials; 86 percent of Kunshan government officials are Party members. Party Secretary Guan Aiguo described the role of Party and state in promoting Kunshan’s business as follows: “We manage the stage, and the companies are the actors. By understanding our role and theirs, both are able to concentrate on success .”13 As Kunshan’s leading native entrepreneur, Song Zhenghuan, president of the Goodbaby Group, described Kunshan’s practice of shooting first and asking permission later: “When I was young, I worked on a farm. Each day I would pass a pond and notice that the ducks would often be walking around quacking loudly on the bank, until one duck jumped in. As soon as the first duck was in the water, the rest would follow. Looking at them, I decided that when I knew where I wanted to go, I would not wait for someone else to lead. This had guided my actions and seems to apply to Kunshan’s government as well.”

In 2011, the per capita GDP of Kunshan, counting only its 723,644 registered permanent residents, was approximately $ 52,000; even counting Kunshan’s migrant workers, the per capita GDP of Kunshan’s 2 million residents was $ 19,000. It is by any measure the wealthiest city in China. Chinese government is not always an opaque inflexible organism, but it adapts in unpredictable ways.

**ReSource Pro**. Another example of the enabling role of local government in helping a company of strategic importance to it is the case of ReSource Pro and the city of Qingdao. 14 ReSource Pro is a thousand-person outsourcing operation, only four years old, located in Qingdao on the southern coast of Shandong. Its business is to take portions of the back offices of US insurance brokers and move the activities to China, where they can be done more efficiently (75 percent labor cost advantage) and still be done in a timely fashion.

Steadily growing in both revenues and profits, understanding the sources of ReSource Pro’s success provides important lessons. First, it is a completely English-fluent office, since its staff must be in continuous contact telephonically and electronically with their English-speaking customers in the United States. The average age of its workforce is twenty-six, 85 percent are female, and all but two or three are Chinese citizens. They are mostly college graduates, the majority coming from Qingdao. Hiring is a highly focused process whose objective is to screen employees for ability, and especially for English skills. Overwhelmingly, men in the Qingdao schools and universities concentrate on math and science in college, while women focus on languages, explaining why this workforce is so skewed toward women.

ReSource Pro is a highly desirable employer from the viewpoint of the Qingdao government, which has given it many tax concessions and helped get it attractive office locations. These concessions were granted because the company provides a thousand good entry -level white-collar jobs for graduates of the local university, thus keeping them in Qingdao. The company also provides an opportunity for the staff to develop work histories and acquire new skills, and thus develops excellent staff for other employers in the region. High turnover of ReSource Pro’s staff, though undesirable from the company’s point of view, is a benefit for the city as it tries to attract new employers who need to build a quick nucleus of English-speaking local staff. This is an example of a foreign company being valued by the local government because it is bringing new skills to the area (in this case, opportunities for staff to learn to operate in English and thus helping Qingdao compete for other larger global employers). The manager, an American citizen, is fluent in Chinese and has a Chinese spouse, which blurs important tension points and helps to make the company feel appropriately local to the government. Its major global competitor is an Indian company. ReSource Pro competes effectively with its rival because its employees’ English is so good that it is actually a positive differentiator. Key staff travel regularly to the United States, visiting clients, making the company more global in outlook— an advantage for Qingdao as well.

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As these examples show, the Party -State at all levels is a critical influencer of success. With its active encouragement and supporting infrastructure, many things can become possible. When a firm creates jobs in a capital-starved world, alternative financing vehicles can be tolerated, at least for a while. But if a company threatens government control, even unwittingly, it is doomed. This is a state where management of information is key: that was Google’s downfall. Finally, government at all levels is important.

**Infrastructure**

The rapid development of hard infrastructure and much slower development of soft infrastructure vis-à-vis the West creates both commercial opportunities and risks. We can see this in the examples of Sealed Air, Yili, and LongTop.

**Sealed Air**. By contributing to the development of soft infrastructure such as national standards, an organization can be seen as a good citizen of China. Sealed Air, the American packaging company, has built a successful operation of five hundred people in China on this basis. 15 Packaging in the meat products area offers the opportunity to significantly improve both the safety and the yield of meat products for the Chinese consumer. Its business is based on the assumption that urban supermarkets, not open markets, are the future, and that meat and other perishables have to be packaged for that purpose. It assumes, too, that instead of every fifth truck from Nanjing to Shanghai carrying live pigs (as was still the case in 2008), a modern refrigerated trucking industry will eventually be able to get Sealed Air’s well-sealed packages to the supermarkets in good condition. Critical to the company’s success has been its tireless work over a long period of time on various government standard-setting bodies to help China evolve and implement standards to catch up with global best practices in food quality and hygiene. In this context, Sealed Air is a desirable company to both the provincial and the national government because it is using its technology and skills to help an important industry in China to raise its standards to world level. By being in the center of this standard-setting process, Sealed Air is seen as improving the health and safety of the Chinese population and thus is welcome to grow and to make profits.

**Yili.** The absence of standards can have devastating consequences. Consider the case of Yili, a publicly traded state-owned dairy company located in Inner Mongolia. 16 Over the past fifteen years, the dairy industry’s growth has been led by Yili, which had convinced tens of millions of lactose-intolerant Chinese, who historically have not liked milk, that only milk will help their children grow.

Yili invested in extensive research and development (with a staff of five hundred in R& D) and worked with medical experts to create additives to make milk more digestible to the Chinese. Its marketing platform took advantage of Chinese consumers’ association of milk with Inner Mongolia’s green grassland.

Yili also confronted the fact that milk had been considered a luxury product consumed only by the wealthy and the foreign. It wanted to make it a middle-class drink. But keeping milk fresh and affordable was a major challenge. The cold-chain process that kept pasteurized milk fresh for seven to ten days was costly in terms of both production and logistics, thus keeping prices high. To make milk available to a geographically wide range of consumers, Yili rapidly acquired smaller rivals, expanding its network. It also adopted the ultra-high-temperature (UHT) process, widely used in Europe, to dramatically extend the shelf life of its milk.

But Yili’s success also rested on changes in the countryside, especially in the nature of dairy farming in China. Yili developed a new industry-transforming milk-collection system. It set up local milk-collection stations with milking machines to which farmers could bring their cows. This alleviated the previous system of collecting and transporting multiple barrels of milk from individual farms across multiple villages and also moved the industry from hand milking to automated milking. All of this was facilitated by the new

infrastructure of railroads and highways. By 2008, Yili had seventy thousand employees and a nationwide distribution channel. In short, it industrialized and expanded enormously, and in the process enriched Inner Mongolia. In honor of its contribution, Yili was named the official yogurt of the Olympics. This story of innovation and marketing makes for a terrific MBA case.

But the rise of Yili and, especially, its competitors for the new milk market had hidden dangers and costs. Everything was suddenly put at risk by the systemic poisoning of children through the addition of melamine in milk products in 2008. Yili senior management was unaware of the problem in its own supply chain, and powerless to do much about its competitors. Either way, the damage to consumer confidence was done. Chinese increasingly favored imported dairy products, and especially baby formula. Two of Yili’s competitors’ key executives were sentenced to death, while others received life sentences. A belated result was the subsequent development and implementation of the same type of quality and inspection standards as in the Pure Food and Drug Act of 1907 in the United States. These standards are being rapidly adopted by this industry. Still, as Yili’s case shows, it is easier to create the hard technology of distribution than the soft technology of standards and the processes for enforcing them.

**LongTop.** LongTop illustrates the absence of another type of soft infrastructure, that of reliable accounting and auditing. LongTop was a Chinese software company that, in 2010, was the largest provider of banking software products to the Chinese banking industry. Founded in 1996 as a systems integration company, in 2001 it became a software and solutions provider and subsequently had very significant growth. Its clients included three of the four main state-owned banks as well as most of the thirteen national commercial banks and several large insurance companies. It provided both customer-designed and standardized software solutions. IDC, the independent research firm, named LongTop number one in performance in 2008 and 2009 in the banking solutions market. In October 2007 it became the first Chinese software company to be listed on the NYSE. In short, LongTop was a globally acknowledged start-up. Alas, its foundation was made of clay.

In June 2011, LongTop was delisted from the NYSE after its auditor, Deloitte (which had given LongTop four years of consecutive clean opinions), resigned the account after being unable to verify its cash balances, which were ultimately discovered to be almost entirely nonexistent. It turns out that the bank’s branches were told by the company not to cooperate with Deloitte in the course of the audit . The banks were even told by LongTop that Deloitte was not the firm’s auditor. When Deloitte asked LongTop’s non-executive chairman how it happened and whose fault it was, after pausing for a moment, he said tersely, “Senior management!” The company is bankrupt as we write this.

In short, the institutions of financial and legal compliance are frailer in China than in the United States (even after acknowledging the realities of Enron and WorldCom ). All is not what you read. It is our belief that these issues will be very hard to resolve. Many Chinese companies listed on the NYSE are now delisting to escape onerous requirements like Sarbanes– Oxley. Others are being tarred by the China brush and, getting what they

 see as unacceptable multiples, are also delisting. They plan to go private and relist in China at higher multiples.

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Understanding and managing the realities of soft infrastructure is hard. The gaps in habits and mind-sets are nonobvious and deep. It is the gaps here that will be the most enduring and hard to manage and leave us deeply concerned about China’s ability to lead globally.

**The New Chinese Consumer**

Conventional wisdom holds that consumer consumption growth is key to China’s future prosperity. Although real constraints impede entrepreneurial success (as noted in chapter 4 ), we believe conventional wisdom is right in this case. Two of the authors first visited China in 1979– 1980, and a consumer -led demand explosion is the last thing either of us dreamed of at that time. At the airport bookstore, The Selected Works of Mao Zedong was the primary offering. The ever-present “Friendship Store ” was stocked with tasteless piles of downmarket trinkets and clothing. Shanghai’s Peace Hotel— once a palace on the Bund in the Republican era— was a relic. Meat hanging from the store ceiling as the flies buzzed around did not produce visions of cleanliness. State-owned restaurants filled every glass of beer before a single patron arrived, in the name of socialist efficiency. The concept of customer service seemed not to exist.

It is a very different world in 2014. Today, on the streets of China’s leading cities, you can view Chinese and international elites as well as— and in much larger numbers— members of a new middle class that is as large as the entire population of the United States. Starbucks and KFC may be found not far from Michelin-starred restaurants. Although these changes are most evident in pace-setting cities such as Shanghai, Beijing, and Guangzhou, an entrepreneurial and consumption revolution can be found also in inland cities across the mainland. How fast and deep will this change run across China in the coming years? The answer is not clear. The need for personal savings to cover missing social infrastructure, the reemergence of state-owned enterprises as powerhouses, and the widening gap between the top and the bottom are real barriers.

Consumption in China is shaping and being shaped by a new generation of entrepreneurs and businesses, private and public . They are changing the clothes Chinese wear, the foods and beverages they consume, the homes they live in, and the means by which they travel across town and about the country. In only a decade, China has adopted all the trappings of a consumer economy. Every aspect of the marketing mix is in transition. Chinese consumption is being shaped, too, by the omnipresent role of Party and state in setting the rules and boundaries of private Chinese and foreign enterprise.

China’s new middle-class consumers have become brand-conscious in an incredibly short period of time. Brand as a concept is now part of China’s marketing mix, but with its short history, is still evolving in impact and complexity. In 1978, there were few national brands in China, just suppliers of items all manufactured in China by state-owned enterprises. (The best “brand” in those days was anything “made in Shanghai.” ) Nothing could be farther from this world in 2013. In selected categories, most major global brands are already in China, fighting the same battles as in other parts of the world. Coke and Pepsi, for example, backed by local advertising and product line extensions, are fighting nationwide for control of the bottled sodas categories. Product innovation, intense detail work, and creative advertising in recent years have all combined to give Coke an edge as the product categories continue to grow in size. Coke’s chief Chinese competitor, the Hangzhou-based Wahaha Group, under its charismatic CEO, Zong Qinghou, has proven a

canny competitor in secondary and tertiary cities. Its Future Cola is marketed with Chinese flags on the label as “the Chinese people’s own cola” and is third in national market share, right behind Pepsi.

A similar battle is taking place in the athletic shoe sector, with Nike and Adidas having brought the full strength of their brands to this market in the leading urban centers. Initially satisfied with their position there, they have now pushed down to tier-two and -three cities where they are putting a domestic brand, Li Ning, under great pressure. Li Ning, a China-originated and -based apparel/ shoe company, feels much like Nike when you visit its campus, except everything is half scale. The swimming pool is smaller, there are fewer basketball courts , and so on. Cofounded by the great Chinese Olympic gymnast Li Ning, its brand has been strongest in the tier-two and -three cities. Increasingly, despite Li Ning’s appearance in the opening ceremonies of the 2008 Summer Olympics, the brand has been outgunned as the global resources of the others have been brought to bear on it.

Another example is the Ford/ GM battle, where both firms are effectively competing and establishing their brand in the world’s largest and fastest-growing automotive market. Ford, for example, has recently doubled its Chinese manufacturing capacity, while in 2011, with sales of over 2.5 million units in a market of 18.5 million, GM’s China operation was a major contributor to the entire corporation’s profits and recovery . The Buick brand, once fading fast in the United States, has been revived because of its popularity in China , where Buicks made in Shanghai combine quality and luxury at a high level— and, perhaps not the least, because Buick had set the standard for international luxury vehicles in pre-Communist China. Finally, fast food outlets like Starbucks, KFC, and McDonald’s have also spread their presence through installation of thousands of outlets across the country.

As the cases of Wahaha and Li Ning show, there has been a steady emergence and strengthening of local brands in the consumer space. Other examples are Qingdao beer, the oldest but now also fastest-growing beer producer in China, and Haier, which is now the standard in white goods. Still others are firms in mid-market children’s clothing, like the Zhejiang Semir Garment Company. Nurtured by advertising, internet promotion, and a softening of internal trade barriers, local and national brands for China are now emerging in significant numbers.

Finally, obsession with brands is taken to extremes in the realm of luxury goods, which are sought not only by the very wealthy but also by the brand-conscious. Today, whether in the French Concession in Shanghai or on Jinyu Hutong in Beijing, opulence and conspicuous consumption at the high end is overwhelming. The emerging practice of giving high-priced gifts to buy favor has helped support portions of the luxury markets. The focus of the new government leadership on corruption in 2013 temporarily chilled the sales of items like luxury watches. But the extent to which a “luxury culture” has permeated the best-off and better-connected is shown by the recent announcement that a Porsche can no longer be an official vehicle for the People’s Liberation Army.

According to a report by Bain & Company, at the end of 2012 , China surpassed the United States to become the world’s largest luxury market. 17 Cartier, for example , has thirty-two stores in eighteen cities in China and hopes to double that number in the next four years; Cartier sees China as becoming its largest market. Tiffany & Co. has fourteen stores in China and expects its China sales to

surpass those of the United States in the next five to ten years. Sales of BMW and Mercedes topped one hundred thousand cars in the first quarter of 2011, as China threatens to topple the United States as the world’s largest luxury car market. The result is an extraordinary series of new markets at the high end with, of course, the potential of destabilizing the economy and triggering social unrest through the envy of the less fortunate. The opportunities for high-end goods and services may be the best in the world, as long as the pendulum of class-based resentment does not swing back.

**Three Winners**

The opportunity to build major organizations and brands for this market is extraordinary. What follows are the stories of three very different winners: China Merchants Bank, Grace Vineyard, and Haidilao.

**China Merchants Bank**. The story of China Merchants Bank is an important one. The five largest banks in China are all state-owned. Headquartered in Shenzhen , China Merchants Bank, a 1987 start-up and China’s first joint-stock bank, is today the sixth largest bank in China (and roughly the same size as the fifth largest). China Merchants made use of available infrastructure and foreign technology while developing its brand and gaining bureaucratic support.

A Chinese law limiting joint-stock and private banks to no more than five new bank branches per year ought to have constrained China Merchants’ growth. Instead, under the leadership of its former president, Ma Weihua, a longtime national banking regulator, China Merchants grew quickly. It did so initially by issuing credit cards, for which bank branches are unnecessary. Expecting one day to compete with large international competitors such as Citibank, China Merchants procured the necessary software from a small Taiwanese bank to support its expansion into this market. By 2003, China Merchants had a cardholder base of six hundred and twenty thousand. At the end of 2007, China Merchants had issued nearly 21 million cards, or 31 percent of all credit cards in China.

Despite the lack of consumer credit rating databases such as Equifax in the United States, personal knowledge of clients and rapid follow-up on delinquencies resulted in China Merchants Bank having credit write-offs that were much lower than global industry standards. Having established a dominant market share, China Merchants increased product profitability through expanded credit card functionality, online banking services, and wealth management services, keeping with its consumer-centered approach to growth. Although its market share fell to 21 percent (still the largest in the industry), cash flow soared. In turn, the bank was able to achieve stronger balance sheet ratios than other major financial institutions, despite initially having far fewer bricks -and-mortar branches.

Today China Merchants Bank has eight hundred branches, including one in New York City, and over sixty thousand employees. The

company is an example of growth by serving unmet consumer demand in a way that aligned with government interests. Driven by a visionary and well-connected leader, China Merchants Bank prospered mightily, with $ 450 billion in assets reported in 2012. In May 2013, Tian Huiyu, who holds a master’s degree in public policy from Columbia University, was named the new president of China Merchants Bank.

**Grace Vineyard**. A second example of innovation and changing tastes is that of Grace Vineyard, which is located in the middle of Shanxi Province, two hours south of the provincial capital of Taiyuan. 19 It was founded by C. K. Chan , a Chinese entrepreneur returned from Indonesia. Chan came of age in China and started his own company in Hong Kong, which he sold in 1994 for $80 million. Believing that China was becoming more consumer -oriented, he bet that the move to middle-class wine consumption that had occurred in much of the developed world was coming to China. In 1997, he invested $ 5 million to establish the wine -making operations of Grace Vineyard. Four years later, his first bottle of wine was produced. Grace Vineyard broke even in 2002 and won its first awards in 2003.

Land for the vineyard was acquired on a fifty-year lease from the local government of Taigu County, Shanxi, in a historically impoverished region . The company initially hired three hundred farmers, and rootstock was acquired from Australia. By 2008, there were four hundred and fifty farmers working in the vineyard and seven hundred thousand bottles per year were being produced, with roughly eighteen months’ inventory being held for aging purposes. This was a very long-term investment, which required a decade or more for payout to the founding entrepreneur.

A family-owned company, Grace Vineyard has specialized in well-priced, high-quality wine in an industry previously dominated by SOE wineries that had been tempted to produce low-quality wines, which would create good financials short-term, but not exciting long-term results. This suited the SOE managers, who normally rotated out of a firm after four or five years to another company . As a consequence, an opening emerged in the market for well-capitalized strategic investors who had patience and an instinct for quality.

This case shows the opportunistic space that has been left for entrepreneurs to work in. In terms of quality, owner-operated vineyards have widely outperformed state-owned enterprises with much greater resources. Their wines are consistently of much higher caliber than Great Wall’s ubiquitous products. Grace keeps its price point geared to international standards of quality. It also displays a trust in the government and local property rights systems, for Grace brings pride and prestige to its home province. It believes that fifty-year leases can be counted on. You cannot build a growing investment that realistically can be cash flow negative for more than a decade if you are concerned about expropriation or the government reneging on commitments. It is a consumer-oriented company that is prospering from emerging middle-class affluence and desire to reach a higher quality of life.

Grace Vineyard is now run by the founder’s intrepid daughter, Judy Chan, and operates boutique shops in leading Chinese cities. Its wine is served in first-class in Cathay Pacific Airlines, is private-labeled by Hong Kong’s Peninsula Hotel, and is at the leading edge of a resurgent Chinese wine industry. In fifty years, the New York Times reported in its annual “Year in Ideas,” Chinese wine

could rival the finest Bordeaux. “Grace Vineyards,” the Times noted, “points to the country’s potential.” 20

**Haidilao**. Our third example, Haidilao, began in central China with the creation of a six-table hotpot restaurant run by a high school dropout on a part-time, after-hours basis with the aid of his family. 21 Built around meticulous quality-control processes, overwhelming focus on service and friendliness (in a country once not known for either in the restaurant business), and driven by the owner’s passion, it was soon drawing long lines of waiting customers. Today, it ranks twentieth in China’s one hundred top dining enterprises and has fifty large hotpot restaurants across the country, including Beijing, that run twenty-four hours a day, seven days a week. Haidilao is prospering mightily in 2014 and currently has fourteen thousand employees. It has recently opened a US branch.

Haidilao’s success is all built on the personal touch and a quality of caring from the bottom to the top. Not a single MBA works there. Quality control and friendliness dominate the sites, which often have three generations of workers from a family from a rural village toiling side by side. Families are queuing up from the home villages to get jobs at Haidilao (which takes care of their every need in the city from housing to schooling). Capital is its only major growth constraint. Haidilao cannot get bank loans, and it does not sell franchises. The owner expressed his strong personal bias toward retaining control in discussions with one of the authors. Selling stock is not an option for him— this is a one-person corporate vision. It is a company in which the government has no strategic interest (apart from standard questions of public health). Quality of its service and product, a deep network of relationships to attract and retain staff, careful attention to cash flow, and a deeply committed and driven CEO have been the drivers of success.

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In summary, much of China’s growth over the past thirty years has depended on an extraordinary cadre of entrepreneurs who have led the way toward building the foundations of a consumer-led economy. Important needs of consumers have not and will not be filled by the state -owned enterprises that have been so important in the infrastructure renovation and build-out. They can be filled only by the energy and creativity of private entrepreneurs and the companies they build and grow to deliver new products and services.

As we have seen, the life of an entrepreneur is not easy in China, and that of a foreign entrepreneur can be more challenging still. But the reality today is that more than 50 percent of the economy, and much more of the growth, comes from the private sector. In short, the long-term growth and health of the Chinese economy depends on entrepreneurs. At every step along the way , however, there are hidden government hurdles at the local, provincial, and national levels as well as infrastructure opportunities and lags that must be understood and mastered by any entrepreneur who is to be successful.

**Private Entrepreneurs in the Shadow of Goliath**

The narratives above tell a story of a series of powerful successes along with instructive failures. Why then are Chinese private -sector CEOs so worried about the future ? Why do they fear the state that has built so much of the infrastructure on which their success has been partly dependent? Why do so many seek to send their assets— and indeed, their children— abroad?

One answer lies in the observation of Chen Dongsheng, the chairman of Taikang Life Insurance Company and the cofounder of the Chinese Entrepreneurs’ Forum, whom we met in chapter 1 . Noting that the first decade of the twenty-first century had been a “golden decade” for private firms, he also noted that it had witnessed a powerful resurgence of state-owned enterprises at every level.

The main competitor for the CP Group, for example, is not another private or foreign firm, but the vast state-run foodstuffs company COFCO, the China National Cereals, Oils, and Foodstuffs Corporation. 22 COFCO dates from the early Maoist period and is the nation’s largest food processor, manufacturer, and merchant of agricultural products and one of China’s largest state-owned enterprises. It provides competition to virtually every private player in agribusiness. Grace Vineyard, for example, must contend with the ubiquitous Great Wall wines produced in bulk by COFCO, 95 percent of which are bottled and labeled as of Chinese origin, but perhaps half of which contain unlabeled and undistinguished imported vat wines.

At the local level, small start-up firms can find themselves completely at the mercy of regional officials whose power is unchecked. A decade ago, remote Jingbian County in northern Shaanxi Province was the site of some four thousand small oil wells opened by private entrepreneurs and small-scale investors, producing 2 to 3 percent of China’s output of crude oil. They had bought their drilling rights legally from the local government. But they were too successful. The monopolistic ambitions of the China National Petroleum Corporation and Shaanxi Yanchang Petroleum, the regional state-owned petroleum company, led to the abrogation of contracts and the confiscation of private wells. Local Chinese Communist Party leaders became executives of the regional state-owned corporation, and the entrepreneurs who sued to get their assets back were arrested and jailed for disturbing the peace. To paraphrase former premier Zhu Rongji again: “Guojin mintui”—the state advances, the private sector retreats.” 23

We conclude by quoting China’s most visibly successful and innovative entrepreneur, Jack Ma of Alibaba. 24 At the 2011 annual gathering of his Taobao employees in Hangzhou, the capital of China’s leading private enterprises, Ma talked about the difference between Alibaba and Taobao on the one hand, and state-owned enterprises on the other. “They are big because they are state-owned,” he shouted. “We are big because we are good!” Then, in am imaginative play on words, he noted: “They are the so-called guoying [nationally run] companies. We are the truly guoyou [national] companies.” The real public companies, serving the needs of the people, in other words, were private enterprises: “We are China’s real national treasures.”

Jack Ma is right. But will his be the vision of the future?

**Important Questions to Ask When Doing Business in China**

* Does my firm know key ministries and Party organizations that influence our success?
* Do we know the key people, and are we regularly interacting with them and their subordinates?
* Who are the up-and-coming leaders in the Party and government organizations with which we must deal?
* Does my firm know the key local municipal and government units and Party structure that influence our success?
* Are we interacting with key individuals and their subordinates?
* What unique contributions and technologies does my firm bring to China?
* Are we emphasizing them in all our Party and government conversations?
* What will our future contributions be?
* What unique contributions and technologies is my firm bringing to the province and city? Are we clearly communicating with them?
* What will our future contributions be? What emergent hardware or software infrastructures will impact our products and operations? Are we prepared for them?
* Is my firm building a competitive brand? Is it both nationally and regionally focused?
* Does my firm have appropriate regional marketing strategies? Are they evolving?